Foreign Offset Demands in Defense and Civil Aerospace Transactions

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EXECUTIVE SUMMARY

This report provides an overview of offset practices in the defense and civil aerospace trade, an assessment of U.S. policy on offsets, and proposals for congressional consideration in the 106th Congress.

Offsets are a form of countertrade required by foreign governments when they procure certain military and large civilian products. In general, offset agreements commit U.S. sellers to provide technology, purchase components produced in the buyer country, or provide other forms of assistance to the buyer country that go beyond compensation economically necessary to support the sale.

Prime contractors in the U.S. take the view that offsets are a nuisance and a cost of doing business internationally in a competitive market for civil and military aerospace products. Aerospace workers, on the other hand, take the view that increasingly high offset concessions in aerospace sales are creating new foreign competitors and place the industry on a path to permanent employment decline. They cite estimates that by 2013, offsets and other forms of foreign outsourcing could result in the loss of 46,083 direct aerospace jobs and 34,470 other jobs that provide inputs to the aerospace industry.

Domestic suppliers, which provide aerospace goods and services as subcontractors, also complain of financial losses caused by offsets. Most suppliers surveyed by the Bureau of Export Administration and the Trade Promotion Coordinating Committee reported that offsets had adversely affected sales, helped create foreign competitors, and contributed to overproduction. A segment of the supplier base, however, benefits from offsets, because in some cases offsets improve market access and establish business relationships with foreign firms.

This report reviews: (1) statements of U.S. policy with respect to offsets; (2) the adequacy of information on offsets currently collected by the Department of Commerce; (3) opportunities to address offsets in international agreements; and (4) opportunities in domestic worker assistance programs to address the negative impacts caused by offsets. It makes the following conclusions and recommendations:

- ***Current U.S. Offset Policy Is Weak:*** Since 1978, U.S. policy has been characterized by noninvolvement in offsets. Although the U.S. government does not enter into or overtly encourage firms to enter into offsets agreements, it leaves the decision of whether to enter into offset agreements entirely to the discretion of prime manufacturers. This approach ignores the impact of offsets on domestic employment and the supplier base, and subordinates the long-term position of the aerospace industry to short-term gains derived from individual transactions.

  Recommendation: United States policy on offsets could be strengthened significantly by legislation establishing a high-level commission, composed of representatives of government, affected industry sectors, labor, and academia, to review current offset policy, recommend modifications to the current policy, and propose a plan for the reduction of detrimental effects of offsets.
- ***There is Insufficient Information to Understand the Impacts of Offsets on***

Employment: Information currently collected by the Bureau of Export Administration on military exports is too generalized to assess the impact of defense-related aerospace offsets on employment, aerospace industry suppliers, and non-aerospace businesses affected by offset arrangements. In addition, this information cannot be used to identify suppliers that unknowingly lose business as a consequence of offsets. In the case of offsets required as part of civil aerospace sales, there are no reporting requirements at all.

Recommendation: Better information about the impacts of offsets could be obtained through legislation requiring aerospace contractors involved in significant offsets to provide to the Bureau of Export Administration (1) a copy of the transaction papers executed in connection with both defense and civil aerospace offsets, and (2) any documents periodically provided to foreign governments relating to their performance of offset obligations. Proprietary business information would remain confidential but could be used by the Bureau of Export Administration to publish aggregated data and analysis on the impact of offsets.

- ***International Agreements Are Insufficient to Prevent the Use of Offsets:*** Generally, restrictions on defense offsets are excluded from international trade agreements under exceptions for actions taken in the interest of national security. While there are some restrictions on civil aerospace offsets in international agreements, these restrictions are weak, and there has been significant debate about whether these restrictions prohibit offsets. In fact, only the European Community and the U.S. have expressly agreed to interpret these rules to bar offsets in the context of civil aerospace.

  Recommendation: Prospects for stronger international agreements could be enhanced by legislation that encourages the Administration to negotiate international agreements that prevent the use of offsets.

- ***Worker Assistance Programs Are Insufficient to Respond to the Effects of Offsets:*** Although worker assistance programs help retrain workers for employment in other fields and supply financial security for workers unable to convert their skills, none has specifically dealt with the effects of offsets on U.S. workers. In addition, although most programs offer assistance regardless of the reason workers are terminated or laid off, only the Trade Adjustment Assistance program provides significant financial assistance, and its application to workers who lose their jobs because of offsets is uncertain.

  Recommendation: Workers in the aerospace and related industries would be helped substantially by legislation providing financial support, retraining, relocation and similar assistance to employees who lose their jobs due to offsets.

I. BACKGROUND

A. Offsets Defined

Offsets are a form of countertrade required by foreign governments in the procurement of military and certain large civilian products.[1] In general, offset agreements commit the seller firm to provide technology, purchase locally produced components, or provide other forms of assistance to the buyer country that go beyond compensation economically necessary to support the sale.[2] In other words, they are non-cash "sweeteners" attached to export sales, typically set forth in side agreements and provided to the buyer country over a period of time.

In the context of civil and military aerospace sales, the focus of this report, U.S. government agencies have articulated definitions of offsets that differ primarily in the extent to which compensation must be required as a matter of foreign government policy.[3] In 1986, a U.S. government interagency group, focusing on military sales, defined offsets as "industrial

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[1] Kwabena Anyane-Ntow & Santhi C. Harvey, *A Countertrade Primer: A Look at a Growing Trend That Demands Management*, Management Accounting (USA) (Apr. 1, 1995). Countertrade is a reciprocal exchange involving little or no transfer of funds. It describes a wide range of trade arrangements in which goods, services, and technologies are exchanged in addition to, or in place of, money. *Id.*

[2]David C. Mowery, *Offsets in Commercial and Military Aerospace: An Overview*, Symposium Papers on Trends and Challenges in Aerospace Offsets, 1 (Jan. 14, 1998) [hereinafter Mowery].

[3]In 1989, Congress also described offsets in defense trade:

> (1) Many contracts entered into by United States firms for the supply of weapon systems or defense-related items to foreign countries and foreign firms are subject to contractual arrangements under which United States firms must agree --
>
> > (A) to have a specified percentage of work under, or monetary amount of, the contract performed by one or more foreign firms;
> >
> > (B) to purchase a specified amount or quantity of unrelated goods or services from domestic sources of such foreign countries; or
> >
> > (C) to invest a specified amount in domestic businesses of such foreign countries.
>
> Such contractual arrangements, known as "offsets," are a component of international trade and could have an impact on United States defense industry opportunities in domestic and foreign markets.

National Defense Authorization Act for FY 1989, Pub. L. 100-456, § 825(a) [hereinafter 1989 Defense Authorization].

compensation practices required as a condition of purchase in either government-to-government or commercial sales of defense articles and/or defense services as specified in the International Traffic in Arms Regulations."[4] The definition provides that compensation to the purchaser is required as a condition of sale, but it does not address whether offsets are always a function of government policy or may instead result from competitive pressures in the marketplace.

The General Accounting Office, examining increasing offset requirements associated with military exports, recognized that foreign governments may demand offsets informally, as a criterion considered in the award of contracts.[5] According to the GAO definition, offsets are "the entire range of industrial and commercial compensation practices provided to foreign governments and firms as inducements or conditions for the purchase of military goods and services."[6]

The Trade Promotion Coordinating Committee (TPCC), a group consisting of representatives of 19 federal agencies, addressing offsets in its *National Export Strategy*, extended the term beyond military trade to the civil aerospace industry, and identified its core element to be mandatory compensation imposed by a foreign government. According to the TPCC, offsets are "mandatory requirements by a buyer government that a seller provide them compensation in a defense good, government-to-government or commercial transaction."[7] Though similar in form, offsets are fundamentally different than voluntary international collaboration, which takes place in the absence of government pressures.[8]

B. Mechanics of Offsets

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[4]U.S. Department of Commerce, Bureau of Export Administration, *Offsets in Defense Trade: Report to Congress*, 2 (August 1997) [hereinafter *Section 309 Report*].

[5]*See* U.S. General Accounting Office, *Military Exports: Offset Demands Continue to Grow* (April 1996), 23 (noting that the United Kingdom does not impose mandatory guidelines for offsets but instead uses offsets as an "assessment factor in contract evaluations") [hereinafter GAO: *Offset Demands Continue to Grow*]; *compare* U.S. General Accounting Office, *Military Exports: Implementation of Recent Offset Legislation* 1 (Dec. 1990) (GAO/NSAID 91-13) [hereinafter GAO: *Recent Offset Legislation*] (defining offsets as a "range of industrial and commercial practices required by foreign governments and firms as a condition for the purchase of military exports") (emphasis added) *with* GAO: *Offset Demands Continue to Grow* at 1 (defining offsets as "the entire range of industrial and commercial compensation practices provided to foreign governments and firms as inducements or conditions") (emphasis added).

[6]*Id.; see generally* K. Barry Marvel, *International Offsets: An International Trade Development Tool*, Contract Management, 4 (Oct. 1995) [hereinafter Marvel].

[7]U.S. Trade Promotion Coordinating Committee, *National Export Strategy Toward the Next American Century: A U.S. Strategic Response to Foreign Competitive Practices*, 31 n.1 (1997) [hereinafter *1997 National Export Strategy*].

[8]*Id.* at 52.

Offset obligations usually are set forth in side agreements. At the time of the agreement, the seller typically commits to providing a defined offset benefit over a period of time, which may amount to a percentage of -- or even exceed -- the value of the underlying sales contract.[9] The offset obligation is maintained essentially as an account, and offset benefits provided by the seller over the course of the contract are measured as offset credits against that account. The offset agreement typically defines the types of activities that are eligible for offset credit.[10]

During the period of the offset commitment, the parties negotiate over the amount of offset credit to be awarded for different activities. Many aerospace companies employ offsets managers for this purpose, and country-parties similarly utilize government ministries.[11] In exchange for highly desirable offset activities, such as the provision of advanced technology or training, countries often apply "multipliers" and grant additional offset credits.[12] In its simplest form, a negotiated multiplier will increase the cash value of an offset by a specified multiple. For example, if an offset project is valued at $1,000, a multiplier of 10 will increase the amount of offset credits to $10,000.[13] During the period of the offset obligation, prime contractors submit reports to the buyer governments, usually on a quarterly basis, describing in detail the offset activities undertaken.[14]

C. Varieties of Offsets

Offset arrangements appear in many forms, dictated primarily by the industrial policy needs of the buyer country and the imagination of the parties to each transaction.[15] Although new forms are constantly evolving, they generally fall into two categories, direct and indirect offsets. Direct offsets are arrangements in which the benefit provided to the buyer country is directly

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[9]Even though the value of offset obligations may exceed the value of the underlying contract, suppliers earn profits two ways. First, offset value may be inflated by the operation of multipliers. Second, the time value of money accrues to the vendors under offset arrangements. Bureau of Export Administration official Brad Botwin explained that performance of the underlying contract may take place over 2 or 3 years, for example. The associated offset obligation may be fulfilled over a longer period, perhaps 10 or 15 years. *See Transcript of Community Meeting Held by Representative Henry A. Waxman and Representative John F. Tierney*, Peabody, Massachusetts, at 41 (June 29, 1998) [hereinafter "*Community Meeting Tr.*"].

[10]GAO: *Offset Demands Continue to Grow* at 2.

[11]Briefing by Brad Botwin, Director, Strategic Analysis Division, Office of Strategic Industries and Economic Security, U.S. Department of Commerce (Aug. 3, 1998).

[12]GAO: *Offset Demands Continue to Grow* at 2.

[13]*Id.* at 2 n.4.

[14]*Id.*

[15]*See* GAO: *Offset Demands Continue to Grow* at 3.

related to the aerospace system sold in the underlying transaction. For example, in a commercial sale of aircraft, the seller might be required to assemble the landing gear in the buyer country instead of in a subcontractor's facility in the United States. Because this side agreement is directly related to the underlying aircraft sale, it would be considered a direct offset.

Indirect offsets, by contrast, involve activities unrelated to the system sold in the underlying transaction. In the example of an aircraft sale, an indirect offset arrangement might require the vendor to purchase its office furniture from a company within the buyer country. This would be termed an indirect offset because, even though office furniture is in no way related to aircraft, the furniture sale is nonetheless a component of the underlying aircraft sale.

The distinction between direct and indirect offsets is useful because each has a different impact on domestic suppliers and workers. Because direct offsets involve activities related to the underlying aerospace sale, they affect the employment and subcontractor base in the aerospace sector. Indirect offsets, on the other hand, affect a host of domestic industries and related employment that may have no connection to defense or civil aerospace. The impact of indirect offsets, which represent an ever increasing percentage of offset arrangements, is difficult to assess, because their effects are diffused throughout the economy and because the essential details of these arrangements are not reported to the Department of Commerce.

The impact of indirect offsets on suppliers in the United States is illustrated by one oft-cited example. As part of a sale of F-18 fighter aircraft, the government of Finland required the purchase of a $50 million papermaking machine produced in Finland. Instead of purchasing the machine itself, Northrop offered a $1.5 million incentive payment to a U.S. company to buy the Finnish-made product. The deal cost a domestic manufacturer of papermaking machines a sale and may have resulted in the loss of jobs in the paper-making industry.[16]

The General Accounting Office has examined proprietary transaction papers in a sample of military aerospace sales and distilled several apparent varieties of offsets, described below:[17]

1. Co-Production and Subcontracting

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[16]*See* Owen E. Herrnstadt, *The Role of the United States Government in Setting Offset Policy*, Symposium Papers on Trends and Challenges in Aerospace Offsets (National Research Council Jan. 14, 1998). The Feingold Amendment, subsequently enacted in April 1994, prohibits a replication of this precise scenario. Under this provision, U.S. contractors are prohibited from offering incentive payments to a U.S. company to persuade it to buy goods or services from a foreign country in connection with an offset agreement. 22 U.S.C. 2779a; *see generally* U.S. General Accounting Office, *Military Offsets: Regulations Needed to Implement Prohibition on Incentive Payments* (Aug. 1997) (GAO/NSIAD-97-189).

[17]Briefing by Katherine V. Schinasi, Associate Director, National Security and International Affairs Division, Richard E. Burrell, Sr. Senior Evaluator, and Lauri A. Kay, Senior Evaluator, General Accounting Office (July 30, 1998) [hereinafter GAO Briefing (July 30, 1998)].

In a co-production arrangement, a U.S. vendor contracts with one or more companies in the buyer country to assemble, build, or produce articles related to the underlying sale. In a subcontracting arrangement, a U.S. vendor agrees to buy goods or services related to the underlying sale from suppliers in the buyer country. Co-production and subcontracting offsets appeared in 20% of the transactions reviewed by GAO.[18]

> *Example (co-production): In 1991, the government of South Korea and General Dynamics (subsequently acquired by Lockheed Martin) concluded a $5.2 billion transaction for the Korean Fighter Program, involving the purchase and sale of F-16 fighter aircraft. The parties structured the deal so that the government of South Korea purchased twelve of the aircraft off-the-shelf and bought 36 in the form of aircraft kits to be assembled in Korea. In addition, South Korea obtained the right to manufacture an additional 72 F-16s under license.*[19]

> *Example (subcontracting): As part of its sale of Apache attack helicopters to the United Kingdom, valued at nearly $4 billion, McDonnell Douglas (subsequently acquired by Boeing) agreed to purchase from British firms $350 million worth of equipment for the helicopters.*[20]

2. Other Procurement

In this variety of indirect offset arrangement, the prime contractor agrees to purchase goods and services unrelated to the aerospace item sold. According to GAO, this form of offset was present in 9% of the transactions reviewed.[21]

> *Example: Lockheed Martin, as part of its sale of C-130 aircraft to Canada, agreed to purchase assemblies and avionics in Canada for another transport plane, the C-5.*[22]

3. Technology Transfer

In this form of offset arrangement, a U.S. vendor transfers technology, technical assistance, or training to the buyer country. The technology may be related or unrelated to the

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[18] *Id.*

[19] Lora Lumpe, *Sweet Deals, Stolen Jobs*, The Bulletin of the Atomic Scientists, 30 (Sept./Oct. 1994).

[20] GAO: *Offset Demands Continue to Grow* at 7.

[21] GAO Briefing (July 30, 1998).

[22] GAO: *Offset Demands Continue to Grow* at 7.

underlying aerospace item sold.[23] In GAO's review, this form of offset appeared in 48% of the transactions studied.[24]

Example: Lockheed Martin Tactical Aircraft Systems, as part of its sale of F-16 fighter aircraft to South Korea, agreed to transfer manufacturing and assembly expertise, enabling South Korea to assemble from kits and manufacture many of the aircraft sold as part of the deal.[25]

4. Marketing Assistance

In this form of offset, U.S. contractors help foreign companies penetrate U.S. and/or non-U.S. markets, either performing the service in-house or using outside consultants for this purpose. Such offsets were present in 23% of the transactions reviewed by GAO.[26]

Example: As part of its $3 billion sale of F/A-18 fighters, McDonnell Douglas agreed to provide international marketing assistance for the REDIGO training aircraft produced by the Finnish company Valmet Aviation, Inc.[27]

5. Financial Assistance/Investment/Joint Venture

In this form of offset arrangement, a U.S. contractor takes an equity position, provides start-up financing, or provides other services to support a new or existing business entity in the buyer country. According to GAO, such offsets appeared in 13% of the transactions reviewed.[28]

Example: As part of its sale of Apache attack helicopters to the United Arab Emirates, McDonnell-Douglas Helicopter Company entered into several joint ventures in the UAE, developing products, among others, to clean up oil spills and recycling printer cartridges used in photocopiers and laser printers.[29]

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[23]For military aerospace articles, technology transfers either must be approved by the U.S. government as a foreign military sale or, if a commercial sale, must be duly licensed by the State Department. Dual-use aerospace items must be licensed by the Commerce Department in accordance with the applicable export regulations.

[24]GAO Briefing (July 30, 1998).

[25]GAO: *Offset Demands Continue to Grow* at 9.

[26]GAO Briefing (July 30, 1998).

[27]*Finland Signs On For $3 Billion F/A-18 Deal*, Aerospace Financial News (June 19, 1992).

[28]GAO Briefing (July 30, 1998).

[29]GAO: *Offset Demands Continue to Grow* at 10.

D. Differing Views on the Impact of Offsets

Apart from a general consensus that offsets add to the cost of doing business and that unilateral regulation of U.S. companies would exacerbate the offsets problem,[30] segments of the aerospace industry express differing views on the importance and impact of offsets.[31]

1. Labor Unions/Workers

Labor unions take the view that U.S. prime manufacturers are on a course of permanent employment decline as a result of both mandatory offsets and voluntary foreign outsourcing of components and subsystems. According to this view, U.S. and European producers are trapped in a prisoners' dilemma, offering increasingly high offset concessions to conclude aircraft sales, particularly in Asia. In the short run, this sacrifices U.S. (and European) jobs. In the long run, it creates new foreign competitors that further erode employment in the United States.[32]

2. Subcontractors/Suppliers

Although domestic suppliers occasionally benefit from offsets in terms of increased market access, as in certain joint venture or co-production arrangements, they generally express several concerns about offsets. First, in a typical direct offset arrangement, prime manufacturers select foreign suppliers primarily because they generate credits against the manufacturer's offset obligations. When this happens, even competitive domestic suppliers lose sales. Second, technology transfers and other forms of offsets enable foreign suppliers to become more sophisticated and experienced, enabling foreign firms to compete against U.S. companies in other sales. Third, U.S. suppliers express concern that offsets requiring foreign outsourcing can lead to overcapacity in the market, depressing sales and eroding profits.[33]

3. Prime Manufacturers

Prime manufacturers view offsets as a nuisance and as a cost of doing business internationally. In response to criticisms from suppliers and workers, prime manufacturers respond that offsets are an insignificant cause of job loss compared to reduced defense spending and industry consolidation. Prime contractors contend, moreover, that if they did not agree to offsets, they would lose sales to foreign competitors that did. Alluding to lost sales, prime manufacturers assert that "85% of something is better than 100% of nothing," and that offsets are a necessary evil to maintain production in the face of diminishing demand.[34]

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[30] *Community Meeting Tr.* at 18.

[31] *1997 National Export Strategy* at 57-58.

[32] *Id.* at 58.

[33] *See id.*

[34] *Id.*

II. TRENDS AND NEGATIVE IMPACTS

A. Lost Business and Jobs

In 1994, GAO predicted that foreign government demands for offsets in military sales would increase[35] and concluded in 1996 that offset demands had indeed grown.[36] Countries that previously had demanded offsets were demanding more from prime manufacturers and were developing long term commitments to pursue industrial policy goals. Moreover, countries that previously had not asked for offsets had begun to require them as a matter of policy.[37] In its 1997 report to Congress, the Bureau of Export Administration confirmed this trend, reporting continued increases in both new offset obligations and offset activities performed pursuant to existing obligations. According to the report, prime contractors entered into 45 new offset agreements valued at over $6 billion, representing a substantial increase in new obligations over past years, both in overall value and as a percentage of the related export contracts. The report also concluded that indirect offsets constituted an increasing percentage of the total.[38]

The impact of these increasing offset demands on employment and sales in the aerospace industry is difficult to measure. First, job loss in the industry may be attributable to other factors, such as significant reductions in defense spending over the past decade and consolidation of the global aerospace industry. Defense spending in the U.S. has dropped from roughly $370 billion in FY 1987 to less than $240 billion in FY 1997.[39] Western European nations have similarly reduced military spending, resulting in intensified competition between U.S. and European producers.[40] This decrease, coupled with a world-wide recession in the demand for commercial aircraft, resulted in the estimated loss of 545,000 jobs between 1989 and 1995.[41] Second, it is difficult to establish whether a prime contractor awarded a contract to a foreign competitor solely because of an offset or because the foreign competitor offered more favorable terms. Third, as

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[35]U.S. General Accounting Office, *Trade: Offsets in Military Sales* (Apr. 13, 1983) (GAO/NSIAD-84-102).

[36]GAO: *Offset Demands Continue to Grow* at 3.

[37]*Id.*; *but see* Mowery at 9 (acknowledging the increasing importance of indirect offsets but concluding that there is no evidence of increased offsets in recent U.S. military exports).

[38]*1997 Section 309 Report* at i.

[39]Mowery at 25.

[40]*Id*.

[41]Robert E. Scott, *The Effects of Offsets, Outsourcing, and Foreign Competition on Output and Employment in the U.S. Aerospace Industry*, Symposium Papers on Trends and Challenges in Aerospace Offsets, 2 (National Research Council Jan. 14, 1998) [hereinafter Scott, *The Effects of Offsets*].

discussed further in section III.B.1, vendors involved in offsets currently are required to provide information only on the broad industry category affected by the offset.[42] It is therefore difficult to assess the employment impact of even reportable transactions. This problem is even more difficult in indirect offset transactions, where the impact on workers and suppliers is spread across non-aerospace industries.

Notwithstanding these difficulties, Randy Barber and Robert E. Scott, in *Jobs on the Wing*, attempted to forecast the employment consequences of offsets and other trade practices on the aerospace industry. They predicted devastating losses of high wage manufacturing jobs. They also forecast that offset policies and increased foreign competition could place 250,000 jobs at risk in aerospace and related industries in the year 2000, and estimated that as many as 469,000 jobs could be eliminated by 2013.[43] Focusing on direct offsets and other forms of outsourcing, Dr. Scott later narrowed his estimate, predicting that by 2013, offsets and other forms of foreign outsourcing could result in the loss of 46,083 direct aerospace jobs and 34,470 other jobs that provide inputs to the aerospace industry. This would equal 9.6% of aircraft employment in 1994.[44] Dr. Scott contends that this is likely a conservative estimate, in part because it focuses on the impact of direct offsets, which, according to the Bureau of Export Administration (BXA), are diminishing as a percentage share of total offsets.[45]

Apart from employment consequences, offsets also have a detrimental impact on the supplier base in the aerospace and other industries. As with employment, the impact of offsets on suppliers is difficult to assess. Because vendors are required to identify only the broad industry category affected, suppliers often are unaware that offsets are the cause of business losses. Moreover, suppliers that are aware of the adverse affects of offsets may be reluctant to complain of offset practices for fear of undermining their relationships with prime contractors.

The BXA has attempted, with limited success, to assess the impact of offsets on domestic suppliers. In its 1997 report to Congress on offsets in defense trade, BXA included results of its Competitive Enhancement and Diversification Needs Assessment Survey. The Commerce Department sends this survey to small and medium sized businesses, including subcontractors of major defense primes. Approximately 703 subcontractors, or 94% of those targeted, responded to the survey. Of the 17% that indicated any impact by offsets, 78% reported that offsets adversely impacted their business. By contrast, only 22% responded that they were positively impacted by offsets.[46]

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[42]*1997 Section 309 Report, Appendix B.*

[43]Randy Barber & Robert E. Scott, *Jobs on the Wing: Trading Away the Future of the U.S. Aerospace Industry*, 2 (Economic Policy Inst. 1995) [hereinafter *Jobs on the Wing*].

[44]Robert E. Scott, *The Effects of Offsets, Outsourcing, and Foreign Competition on Output and Employment in the U.S. Aerospace Industry, supra*, at 14.

[45]*Id.* at 14-15.

[46]*1997 Section 309 Report* at 60-64.

B. Damage to the Domestic Manufacturing Base

Offsets also appear to undermine key manufacturing industries in the United States. In addition to the direct impact of offsets on the aerospace industry overall, which Barber and Scott predict will contribute to $129 billion in lost sales between 1994 and 2013,[47] offsets contribute to the erosion of other important domestic industries. In its 1997 report, BXA prepared two "sector breakouts" in the aerospace industry, analyzing its data with respect to the machine tool and aerospace gear industries.

In its report, BXA concludes that offsets appear to have injured U.S.-based production in the metalworking machine tool industry. Although the dollar value of offsets in machine tools was only $113 million between 1993-1995, less than 1% of U.S. production, BXA noted that it had a disproportionate effect at the firm level.[48]

In its 1997 report on offsets, BXA also examined the impact on the aerospace gear industry. Though it noted that reduced defense spending caused a profound impact on this industry, offsets also caused significant losses in this industry. BXA noted that seven aerospace gear companies reported a negative impact from offsets, and none reported positive impacts.[49]

C. National Security Concerns

The Department of Defense historically has not opposed the use of offsets when they are used as a means of promoting uniformity of weapons systems for joint operations, lowering unit costs for its own acquisitions, and maintaining production lines for weapon systems.[50] Although offsets involving transfer of sensitive technology or information must withstand a national security review and, in the case of direct commercial sales, be duly licensed, critics of offsets argue that the practice nonetheless enhances the capabilities of potential adversaries and contributes to the proliferation of high technology weapons.

Congress recognized the potential national security consequences of offsets as part of the

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[47] *Jobs on the Wing* at 2.

[48] *1997 Section 309 Report* at 54-55.

[49] *Id. at* 56-57.

[50] GAO Briefing (July 30, 1998); *see also* Federation of American Scientists, *Market Trends: Anything Goes*, Arms Sales Monitor No. 28 (Feb. 15, 1995) (http://www.fas.org/asmp/asm28.htm). Prior to 1978, the U.S. government encouraged the use of offsets and assisted prime contractors in including offset provisions in letters of offer and acceptance under the Foreign Military Sales Program. In 1978, after a subcontractor's bankruptcy caused the U.S. government to default on an offset agreement, Assistant Secretary of Defense Charles Duncan issued a memorandum declaring that offset agreements were a matter between the private contractor and the foreign government alone, and that the U.S. would no longer be involved in such agreements. This position has been the basis for U.S. policy ever since. Marvel at 4-5.

1989 Defense Authorization Act. That legislation prohibits any official of the United States from entering into an agreement to transfer defense technology to a foreign government in connection with a contract subject to an offset agreement, if the agreement would "significantly and adversely affect the defense industrial base of the United States and would result in a substantial financial loss to a United States firm."[51] The 1989 Act also required the President to establish a comprehensive policy on transfer of technology in connection with offset arrangements, and required any U.S. firm entering into a defense related sale, subject to an offset arrangement exceeding $50 million, to provide notification to the Secretary of Defense.[52] After President Bush issued a policy statement on offsets, GAO noted that the policy failed to address technology transfer, as required by this statute.[53] GAO also reported that the Department of Defense had failed to implement the offset notification requirement.[54] The Department of Defense has not satisfied this requirement to date.

In its *1997 National Export Strategy*, the Trade Promotion Coordinating Committee addressed the national security impact of offsets and suggested that they were insignificant. According to the TPCC, because technology is perishable, old technology is not likely to undermine U.S. national security interests. Nor, for that matter, is the transfer of such technology likely to undermine the competitiveness of U.S. industries. In addition, the TPCC pointed out that compensation received from the sale of old technology helps defray the cost of developing new technology.[55]

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[51]10 U.S.C. § 2532(b).

[52]*Id.* § 2532(a)(1).

[53]GAO: *Recent Offset Legislation* at 2.

[54]*Id.* at 7.

[55]*1997 National Export Strategy* at 61.

III. WEAKNESSES OF U.S. GOVERNMENT POLICY

A. Priority of Offsets

1. Policy of Noninvolvement

In response to a requirement set forth in the 1989 Defense Authorization,[56] President Bush, in April 1990, issued the first formal statement of policy on offsets. This statement articulated a policy of noninvolvement and provided:

> Mindful of the need to minimize the adverse effects of offsets in military exports, while ensuring that the ability of U.S. firms to compete for military export sales is not undermined, the President has established the following policy:
>
> - No agency of the U.S. government shall encourage, enter directly into, or commit U.S. firms to any offset arrangement in connection with the sale of defense goods or services to foreign governments.
>
> - U.S. government funds shall not be used to finance offsets in security assistance transactions except in accordance with currently established policies and procedures.
>
> - Nothing in this policy shall prevent agencies of the U.S. government from fulfilling obligations incurred through international agreements entered into prior to the issuance of this policy.
>
> - The decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved.
>
> - Any exceptions to this policy must be approved by the President through the National Security Council.

As part of the same statement, the President directed that an interagency team be assembled to consult with foreign nations with a view to limiting the adverse effects of offsets on defense procurement.[57]

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[56]Pub. L. 100-456.

[57]*1997 Section 309 Report, Appendix D*, at 157-58. In keeping with this policy, the Department of Defense (DOD) includes certain boilerplate language in Memoranda of Understanding (MOU) with allied countries. In bilateral umbrella MOUs, DOD includes the following pertaining to offsets: "The governments agree to discuss measures to limit the adverse effects of offsets on the defense industrial base of the two countries." With respect to MOUs developed for specific projects, DOD inserts a mandatory reference to Section 27 of the Arms

In 1990, the GAO reviewed this policy statement to determine whether it complied with the requirements set forth in the 1989 Defense Authorization Act. Apart from technology transfer discussed in section II.C, that Act required the President to establish a comprehensive offset policy addressing U.S. financing of offset arrangements and the effects of offsets on specific subsectors of the U.S. industrial base.[58] The GAO concluded, among other things, that the President had failed to discuss the effects of offsets on U.S. industrial base subsectors, as required by law.[59] GAO further explained that the statement "reaffirms and is consistent with the U.S. government's traditional policy of non-involvement in offset arrangements."[60]

Despite GAO's criticism, in October 1992, Congress enacted amendments to the Defense Production Act of 1950, which codified President Bush's statement of policy on offsets.[61] Since that time, Congress has not altered this statement of U.S. policy.[62]

The Clinton Administration has recently taken steps toward a stronger offset policy. In its *1997 National Export Strategy*, the TPCC, an interagency committee chaired by the Commerce Department and consisting of 18 other federal agencies, stated:

> The U.S. Government has an interest in reducing government-mandated offsets required in military or civil sales which are market distorting and economically inefficient. When foreign governments dictate the particulars of transactions which would otherwise be driven by market considerations, the benefits U.S. companies could derive from a free international market are limited. The Government has a responsibility to further evaluate what can be done to ensure that U.S. economic priorities are not compromised, and that U.S. tax dollars are not misspent when there is U.S. Government involvement in sales with foreign government representatives.[63]

The TPCC recognized that the U.S. should work to discourage foreign governments from imposing offsets. The TPCC noted further that the U.S. government should continue to monitor the effects of offsets on U.S. primes, labor, and suppliers to ensure that government action or inaction does not compromise U.S. interests. Finally, the TPCC observed that the unilateral

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Export Control Act Cooperative, providing that "no requirement shall be imposed by a participant for worksharing or other industrial or commercial compensation in connection with such agreements that are not in accordance with such agreement." *Id.* at 159.

[58]GAO: *Recent Offset Legislation* at 2.

[59]*Id.* at 2.

[60]*Id.*

[61]Pub. L. No. 102-558, § 123.

[62]*See* 50 U.S.C. app. § 2099 notes.

[63]*1997 National Export Strategy* at 62.

adoption of additional measures could disadvantage U.S. companies vis-à-vis foreign competitors that do not face similar restrictions.[64]

2. Current Offset Policy is Weak

The policy articulated in the *1997 National Export Strategy* is stronger than the policy articulated by President Bush, in that it states that: (1) the U.S. will discourage foreign governments from requiring offsets; (2) the U.S. will support U.S. companies forced to comply; and (3) further monitoring is needed. This statement, however, has not resulted in concrete actions to discourage offsets. As a practical matter, U.S. policy remains unchanged, leaving the decision of whether to enter into offsets agreements entirely to the discretion of prime manufacturers.

This policy continues to ignore the impact of offsets on employment and the supplier base, and it subordinates the long-term position of the aerospace industry to short-term financial gains derived from individual transactions. The national policy should state more aggressively the need to enter into bilateral and multilateral agreements to address the offsets problem, and it should require additional information to more accurately assess impacts on employment and the supplier base.

B. Understanding the Impact of Offsets

1. Information Currently Collected

The Bureau of Export Administration annually prepares, pursuant to Section 309 of the Defense Production Act of 1950, as amended, a report on offsets in defense trade. The Secretary of Commerce promulgated regulations in December 1994 requiring two categories of information. First, U.S. firms that enter into new contracts with a foreign government for defense goods and services must report information on new offset agreements, provided the offset agreement exceeds $5 million in value. Second, firms that are directly responsible for performing offset obligations must annually report information on transactions completed pursuant to an offset agreement, provided that the firm claims offset credit of $250,000 or more.[65]

With respect to the first category, new offset agreements, U.S. contractors are required to identify the following:

- Country purchasing the defense article
- Description of the defense article
- Signatories to the offset agreement
- Value of the export sale subject to offset

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[64] *Id.*

[65] 15 C.F.R. § 701.3

- Total value of the offset agreement
- Term (time period) of the offset agreement
- Description of performance measures (i.e., "best efforts," liquidated damages)

With respect to the second category, offset transactions within the past year, U.S. firms must provide more detailed information:

- Country purchasing defense article
- Description of defense article
- Name of entity fulfilling offset transaction, including first tier subcontractors
- Name of entity receiving benefits from offset transaction
- Dollar value of offset credits claimed by fulfilling entity, including multipliers
- Dollar value of offset transaction without multipliers
- Description of the type of offset product or services provided (co-production, technology transfer, etc.)
- Broad industry category in which the offset transaction was fulfilled (e.g., aerospace, electronics, chemicals, industrial machinery, textiles, etc.)
- Direct or indirect offset
- Name of country in which offset was fulfilled

2. Information Collected Is Inadequate to Understand the Problem

Firms supplying information on which industry was affected by the offset transaction use Standard Industrial Codes, which can be as vague as "industrial machinery" or "technical services."[66] Although this is useful information to collect, it fails to provide sufficient detail to assess accurately the impact of offsets on domestic employment and sales. In addition, it cannot be used to identify suppliers that unknowingly lose business as a consequence of offsets. Finally, these reporting requirements apply only to defense offsets, leaving policy makers with little or no information on the consequences of civil aerospace offsets.

Firms performing offset activities routinely provide more detailed information to the country that purchased the underlying export. Buyer countries carefully scrutinize this information to ensure that they get adequate value in exchange for the offset credits they award to U.S. contractors.[67] Although firms readily provide detailed information on offset activities to foreign governments, they not required to produce copies of this information to the BXA. Nor are firms required to provide the BXA copies of transaction papers that are also available to the buyer country.[68] With access to this detailed information, BXA could identify with greater accuracy those U.S. businesses adversely affected by direct and indirect offsets. After this

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[66]Briefing by Brad Botwin, Director, Strategic Analysis Division, Office of Strategic Industries and Economic Security, Bureau of Export Administration (Sept. 8, 1998) [hereinafter Botwin Briefing II].

[67]*Id.*

[68]*Id.*

information is aggregated (to protect the confidentiality of proprietary information) and published in the BXA's annual report on offsets, economists could better calculate the impact of offsets on U.S. employment and the industrial base.

C. International Agreements Are Insufficient to Prevent Use of Offsets

Despite guidance from Congress, international agreements have not been utilized successfully to prohibit offsets in defense or civil aerospace sales. In order to consider potential international solutions to offset-related problems, it is necessary to understand the international framework under which offsets are regulated. Generally, the theory underlying free trade agreements is that offsets are "economically inefficient and market distorting."[69] States that utilize them, however, have not been willing to forego their significant economic and social benefits, or at least have not been persuaded to do so. Although the Clinton Administration has been more active than its predecessors in attempting to negotiate international solutions, more pressure must be placed on foreign offenders to accept multilateral agreements barring this practice in the context of defense and civil aerospace purchases.

Because international agreements treat defense and civil aerospace transactions differently, they are discussed separately below. Generally, defense offsets are universally accepted as actions taken in the interest of national security. With respect to civil aerospace offsets, the Administration has been somewhat more successful in gaining agreement on the application of free trade rules. These rules are unclear, however, about whether offsets are prohibited. In fact, only the European Community (E.C.) and the U.S. have expressly agreed to to limit their own offset demands, expressly interpreting these rules to bar government offsets in the context of civil aerospace.

1. International Agreements Relating to Defense Offsets

The Administration has a current mandate from Congress to negotiate with foreign countries to eliminate the effects of offsets on the defense industrial base. As mentioned above, in 1984 Congress added a new Section 309 to the Defense Production Act of 1950, requiring the President to submit to Congress an annual report on the impact of defense offsets. Congress augmented this system by requiring the President, as part of the 1989 Defense Authorization, to negotiate with foreign countries to eliminate those effects. The President was directed to report to Congress on the progress of international negotiations.[70]

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[69]U.S. Office of Management and Budget, *Offsets in Military Exports*, 23 (April 16, 1990); *see also* Pub. L. 102-558 §123(a) ("certain offsets for military exports are economically inefficient and market distorting").

[70]*Id.* § 825(c)(1) ("The President shall enter into negotiations with foreign countries that have a policy of requiring an offset arrangement in connection with the purchase of defense equipment or supplies from the United States. The negotiations should be conducted with a view to achieving an agreement with the countries concerned that would limit the adverse effects that such arrangements have on the defense industrial base of each such country.").

In addition to requiring the President to attempt to achieve an international solution, Congress directed the President to analyze potential domestic actions to counter offsets, such as offsets in favor of the U.S., demands for offset credits, reductions of U.S. assistance to foreign countries, and the utilization of alternative equivalent advantages.

As discussed in section III.A, the White House issued a statement in April 1990 in an effort to fulfill Congress' demand for greater clarity in U.S. policy on defense offsets. As part of this statement, the Administration emphasized the importance of its obligation to negotiate an international solution. The statement also mentioned the designation of the Department of Defense as lead negotiating agency:

> The President has noted that the time has come to consult with our friends and allies regarding the use of offsets in defense procurements. He has, therefore, directed the Secretary of Defense, in coordination with the Secretary of State, to lead an interagency team to consult with foreign nations with a view to limiting the adverse effects of offsets on defense procurement. The interagency team will report periodically on the results of these consultations and forward any recommendations to the National Security Council.[71]

In 1992, Congress accepted and codified the President's defense offset policy, as well as the President's decision to delegate to the Department of Defense lead negotiating responsibility.[72] Building on these strides, the legislation directed the President to include in each annual *Section 309 Report* a summary and analysis of any bilateral or multilateral negotiations the Administration had conducted. The 1992 legislation also required U.S. negotiators to consider the data and findings set forth in the report. Unfortunately, the Administration's attempts to achieve an international solution to problems related to defense offsets have been unsuccessful.

a. General Agreement on Tariffs and Trade and the World Trade Organization

The General Agreement on Tariffs and Trade[73] clearly permits the use of offsets in the procurement of defense articles by foreign governments. The GATT, an international trade agreement between most nations of the world, was established in 1947 as a result of the work of the United Nations Conference on Trade and Employment. The strategy behind this landmark agreement was to identify various protectionist measures and to convert them into tariffs to be

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[71] In 1989, President Bush had initially delegated these negotiating functions jointly to the Secretary of Defense and the USTR, in coordination with the Secretary of State. Ex. Or. No. 12661 of Dec. 22, 1988, 54 Fed. Reg. 779, effective Dec. 28, 1988, as amended by Ex. Or. No. 12697 of Dec. 22, 1989, 54 Fed. Reg. 53037; Ex. Or. No. 12716 of May 24, 1990, 55 Fed. Reg. 21831; Ex. Or. No. 12774 of Sept. 27, 1991, 56 Fed. Reg. 49835.

[72] *See* Pub. L. 102-558, § 123.

[73] General Agreement on Tariffs and Trade, opened for signature Oct. 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 187 [hereinafter GATT].

reduced incrementally. During the 1994 "Uruguay Round" of trade negotiations, the Administration revised and updated the GATT by lowering tariffs further and by revising GATT's free trade rules in a "GATT 1994." The Administration also was successful in negotiating specific plurilateral and multilateral trade agreements under the GATT framework. These negotiations established the World Trade Organization (WTO), a permanent organization designed to supervise the implementation of GATT and these supplemental trade agreements and to provide a forum for members to address issues affecting trade relations.

A fundamental tenet of free trade established in the original GATT is that GATT parties (now WTO members) may not take measures that cause discrimination against or among competitors based on noncommercial factors. This principle was intended to eliminate governmental interference that distorts commercial transactions otherwise governed by market forces. Two substantive provisions within GATT further this goal: Article 1 requires members to treat products from all other members equally (most favored nation or MFN treatment);[74] and Article 3 requires members to treat foreign products at least as well as their own (national treatment).[75] The term "offsets" does not appear in the GATT, most likely because the use of offsets accelerated after the GATT was established.

Under these fundamental tenets, at least certain types of offsets would be prohibited. For example, a country presumably would violate MFN treatment if it required U.S. companies to fulfill 20% offset obligations, but required European companies to fulfill them at only 10%. Similarly, a country would violate national treatment if it required foreign manufacturers to fulfill offset obligations but did not require the same of national companies. The GATT also elaborated on these tenets by specifically prohibiting domestic content restrictions.[76] For example, if a member purchased products from a foreign company, the member could not demand that some of those products be made of steel from that member's territory. Under this framework, however, it is unclear whether other types of offsets, such as requirements to transfer technology, would be prohibited.

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[74]*Id.* art. 1.1 ("[A]ny advantage, favour, privilege or immunity granted by any contracting party to any product originating or destined for any other country shall be accorded immediately and unconditionally to the like product originating or destined for the territories of all other contracting parties.").

[75]*Id.* art. 3.4 ("[T]he products of the territory of any contracting party imported into the territory of another contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations, and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use."). *See also* art. 2.1(a) (Tariffs, the only acceptable trade barriers under GATT, are permitted as an exception to the national treatment rule, but still must be applied equally to all other members to fulfill the MFN requirement.).

[76]*Id.* art. 3.5 ("No contracting party shall establish or maintain any internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions which requires, directly or indirectly, that any specified amount or proportion of any product must be supplied from domestic sources.").

Regardless of whether GATT's initial free trade provisions would have prohibited current day offset arrangements, other provisions created express exemptions that clearly permit the use of offsets in defense procurement. In particular, GATT explicitly exempts from its nondiscrimination rules any procurement for governmental purposes.[77] In other words, countries may impose offsets under GATT when products are purchased for governmental purposes and not with a view to commercial resale. With respect to defense aerospace equipment, which is purchased solely for governmental purposes, the government procurement exemption would permit foreign countries to utilize offsets despite GATT's nondiscrimination provisions.

More importantly, GATT includes a provision allowing members to take any trade actions they consider necessary to protect their essential security interests.[78] Specifically mentioned are actions relating to traffic in arms, which, by definition, would be considered essential to national security. Thus, in light of the government procurement and national security exemptions, offsets are permitted under GATT for the purchase of defense aerospace articles by foreign governments. Nothing in the 1994 Uruguay Round GATT amendments altered the effect of these provisions.

b. Agreement on Government Procurement

Although the Agreement on Government Procurement[79] was intended to extend nondiscrimination rules to government procurement, its provisions continue to allow countries to use defense offsets to further national security interests. As GATT was being updated in 1994, the Administration and representatives from other countries felt the issue of government procurement should be addressed. These countries adopted the Government Procurement Agreement to close the exemption left by the GATT and to extend MFN and national treatment rules to any government procurement covered by the Agreement.[80]

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[77]*Id.* art. 3.8(a) ("The provisions of this article shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of products purchased for governmental purposes and not with a view to commercial resale or with a view to use in the production of goods for commercial sale.").

[78]*Id.* art. 21 ("Nothing in this Agreement shall be construed . . . to prevent any contracting party from taking any action which it considers necessary for the protection of its security interests (i) relating to fissionable materials or the materials for which they are derived; [or] (ii) relating to the traffic in arms, ammunition and implements of war and to such traffic in other goods and materials as is carried on directly or indirectly for the purpose of supplying a military establishment.").

[79]Agreement on Government Procurement, Apr. 10, 1979, T.I.A.S. No. 10403, 1235 U.N.T.S. 258, as amended in Uruguay Round Trade Agreements, Sept. 27, 1994, H. Doc. No. 103-316 [hereinafter Government Procurement Agreement].

[80]*Id.* art. 3.1 ("[E]ach Party shall provide immediately and unconditionally to the products, services and suppliers of other Parties offering products or services of the Parties, treatment no less favourable than: (a) that accorded to domestic products, services and suppliers

In light of the burgeoning use of offsets since the GATT was first established, and based on several decades of experience with GATT, the Agreement went beyond GATT's original provisions to state expressly that offsets are impermissible.[81] This provision was a great step forward in defining the practice and attempting to eliminate its effects.

There are several drawbacks and exemptions in the Agreement, however, that virtually eradicate its significance with respect to defense purchases. First, as a "plurilateral" agreement, the Government Procurement Agreement is binding only between countries that choose to sign it. Unlike other agreements, its adoption is not required as a prerequisite to membership in the WTO. In addition, since this Agreement represents only an introductory effort to apply free trade rules to government purchases, it does not cover all government procurement. Rather than a comprehensive agreement, this pact allows each Party to determine the types of products and services it will govern.[82] Other impediments are that the Agreement covers purchases only above a certain monetary value and that "developing" countries are permitted to negotiate offsets as part of their accession to the agreement.[83]

More importantly, the Agreement creates an exception, similar to its GATT counterpart, that exempts actions taken in the interest of national security.[84] In other words, countries may impose offset requirements when they determine such arrangements serve their security interests. The effect of this exception is the same as its effect within the GATT -- it virtually engulfs the rule, at least with respect to purchases of defense aerospace equipment.

Examining the national security exemption in more detail, there is an argument that

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[national treatment]; and (b) that accorded to products, services and suppliers of any other Party [MFN].").

[81]*Id.* art. 16.1 ("Entities shall not, in the qualification and selection of suppliers, products or services, or in the evaluation of tenders and awards of contracts, impose, seek or consider offsets."). A footnote defines offsets as "measures used to encourage local development or improve the balance-of-payments accounts by means of domestic content, licensing of technology, investment requirements, counter-trade or similar requirements."

[82]Signatories generally do not apply the Agreement to a significant number of defense purchases. The U.S., for example, does not apply the Agreement to many purchases by the Department of Defense.

[83]Agreement on Government Procurement art. 16.2 ("[A] developing country may at the time of accession negotiate conditions for the use of offsets, such as requirements for the incorporation of domestic content.").

[84]*Id.* art. 23.1 ("Nothing in this Agreement shall be construed to prevent any Party from taking any action or not disclosing any information which it considers necessary for the protection of its essential security interests relating to the procurement of arms, ammunition or war materials, or to procurement indispensable for national security or for national defence purposes.").

indirect offsets, or offset obligations not directly related to the purchase of defense equipment, are not "essential" to protect national security and, for this reason, could be prohibited under the Agreement. As mentioned earlier, a striking trend in aerospace transactions is the increase in indirect offsets. In the purchase of military aircraft, for example, countries have begun to demand indirect offsets in unrelated sectors, such as agriculture or transportation. These unrelated fields are in no way related to the military defense or security of the demanding party.[85]

As an additional complicating factor, however, the national security exemption provides that the burden of making this determination lies with the country claiming the exemption (nothing prevents a Party from "taking any action . . . it considers necessary"). Notably, the U.S. takes the position that such determinations are not reviewable by any international appeals mechanisms.[86] Thus, any attempt to bar defense offsets internationally not only would have to include defense acquisitions within the Agreement's scope, but would have to overcome this obstacle to enforcement as well.

c. North American Free Trade Agreement

The North American Free Trade Agreement,[87] like the GATT and the Government Procurement Agreement, allows offsets in the purchase of defense aerospace equipment in the interest of national security. NAFTA officially entered into force on January 1, 1994, creating a free trade area between Canada, Mexico, and the U.S. GATT expressly allows free trade areas such as NAFTA and recognizes that their primary purpose is to go beyond merely identifying and lowering tariffs. Instead, parties establishing free trade areas are required to eliminate tariffs in substantially all trade between the Parties. NAFTA is intended to work in conjunction with GATT by utilizing many of its free trade rules.[88]

In addition to incorporating GATT's nondiscrimination rules for the three signatories, NAFTA addresses the issue of government procurement in a separate, distinct chapter with rules

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[85]*See generally* section I.C. Although some may argue that the distinction between direct and indirect offsets is vague, U.S. defense manufacturers are required under current law to submit to BXE various information about offset agreements they perform, including whether they are direct or indirect. To date, companies have not encountered difficulty with this requirement.

[86]Although the WTO offers dispute settlement mechanisms, the position of the U.S. government is that national security determinations are not reviewable. An example is the U.S. response to recent WTO challenges to the Helms-Burton sanctions against Cuba.

[87]North American Free Trade Agreement, Dec. 17, 1992, Can.-Mex.-U.S., H. Doc. No. 103-159, 32 I.L.M. 289, 605 (1993) [hereinafter NAFTA].

[88]*Id.* art. 301 (specifying that each Party must accord national treatment to the goods of other Parties in accordance with Article 3 of the GATT).

and conditions much like the Agreement on Government Procurement.[89] This chapter explicitly prohibits offsets and provides a definition almost identical to the definition in the Government Procurement Agreement.

This prohibition does little, however, to prevent offsets in the arena of defense contracting. Besides relating to only three countries, NAFTA applies only to government entities, products, and services listed in separate annexes, which exclude significant defense purchases. In addition, NAFTA governs only transactions over a certain monetary threshold. The most important exception, however, is that NAFTA, like GATT and the Government Procurement Agreement, allows countries to take any trade restrictive actions they consider to be in their national security interests, both generally and in the specific context of government procurement.[90]

d. Outlook for Future Negotiations

The U.S. has made one other attempt to limit offsets in defense procurement, although unsuccessfully. The Administration participated in negotiations in 1992 and 1993 to create a NATO "Code of Conduct," which was to include a list of "Principles for Improving Defense Trade Among the Allies." Among these principles was a relatively weak effort to identify and reduce offsets, at least among NATO countries.[91] Although the U.S. officially viewed this language as providing inadequate discipline on offsets, the entire Code failed for various other reasons and negotiations were never resumed.

The Administration's strategy since this attempt has been to suspend further international negotiations until a domestic consensus is reached on the best way to proceed. The Administration has been attempting to gauge the significance of offsets on domestic industry and national security. In addition, it has brought together major industrial, governmental, and academic representatives in various meetings, symposia, and working groups to discuss competing concerns and alternatives. Unfortunately, this effort appears to lack drive in that there are no stated policy or time guidelines to resolve this process. In fact, in the five years since the NATO negotiations, there have been few signs of progress in formulating an international negotiating strategy. Indeed, exceptional negotiating opportunities, such as the Uruguay Round

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[89] *Id.* art. 1003(1)(a) (requiring national treatment); art. 1003(1)(b) (requiring nondiscrimination); and art. 1003(2) (prohibiting discrimination based on foreign ownership of local suppliers).

[90] *Id.* art. 2102 (creating a general national security exemption); and art. 1021 (creating an exemption for national security in government procurement).

[91] *1996 Section 309 Report* at 68-69 ("[C]ountries will progressively reduce, towards timely elimination, their offset requirements, once they have noted real progress in the opening up of markets, in the transfer of technology, and in the participation in common research, development and production programmes. This process towards elimination will be reciprocal, and will take into account the different approaches to defense trade among members of the alliance.").

and NAFTA negotiations, closed with little discussion of defense offsets.

This lack of interest in pursuing international offset agreements may be due to conflicting views within the Administration on impact and approach. On one hand, the United States Trade Representative (USTR) takes the position that further negotiations on this issue may be unproductive or infeasible. In the first instance, USTR believes foreign countries simply would not agree to eliminate offsets or that the price of obtaining agreement would be too costly to justify any potential benefits. These countries would demand, for instance, that the U.S. cease providing research and development support to the defense industry or eliminate legislative programs such as the Buy America Act, small business set-asides, and minority business set-asides.

In addition, USTR heeds manufacturer warnings about the drawbacks of obtaining an agreement in which relatively few countries prohibit their companies from accepting offset obligations, allowing companies from nonsignatory countries to seize foreign business opportunities. More pragmatically, perhaps, U.S. prime manufacturers do not support, and in some cases actively oppose, any government effort to establish international regulation of offsets. At best, USTR views international negotiations to eliminate offsets as a long-term objective.

Like USTR, the State Department has given priority to issues other than offset negotiations. For example, the State Department has been delinquent in issuing regulations to implement the Feingold Amendment, which prohibits U.S. manufacturers from making incentive payments to U.S. companies or individuals to persuade them to buy goods or services from a foreign country that has an offset arrangement with U.S. manufacturers.[92]

The Department of Defense, rather than actively encouraging foreign countries to agree to an offset prohibition, has proposed an alternative way of dealing with problems related to offsets. The Department of Defense is considering the viability of business consortia among major manufacturers in Europe and the U.S. This proposal has been described as follows:

> [O]ne can imagine the construction of a more cooperative regime for arms sales, where the handful of military powers with any realistic potential to develop the most advanced military systems agrees to some degree of mutual restraint on exports to third parties, perhaps in exchange for some program of industrial and technological cooperation that assures the survival of core defense industrial capabilities deemed essential to national security.[93]

Several commentators have echoed the concerns driving this proposal, arguing that the

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[92]*See* section I.C.1; *see also* note 16.

[93]Kenneth Flamm, *The Policy Context for Military Aerospace Offsets*, in Symposium Papers on Trends and Challenges in Aerospace Offsets, Board on Science, Technology, and Economic Policy, 5 (National Research Council Jan. 14, 1998).

issue of offsets is relatively minor in comparison to other objectives.[94] The goals of the consortia proposal are to encourage cooperation among allied defenses and to reduce proliferation incentives, while at the same time guaranteeing market access for firms in both areas.[95] This focus on systemic shifts in the aerospace industry, however, has withheld attention from immediate issues facing U.S. workers and firms as a result of foreign offset demands. For example, the Department of Defense failed to issue regulations regarding requirements to collect data on offset agreements over $50 million.[96]

On the other hand, the Department of Commerce's Bureau of Export Administration, which now collects offset data submitted by manufacturers, has been the strongest advocate for international negotiations to prohibit offsets. In its 1996 and 1997 *Section 309 Reports*, the Commerce Department documented increasing levels of offset requirements since the defense industry began downsizing. Their forthcoming 1998 report also recommends consulting with trading partners on offsets in the defense trade. The Commerce Department has issued this recommendation in other fora, as well, including within a report to Congress from the TPCC[97] and in a letter from Bill Reinsch, Under Secretary of the Bureau of Export Administration,[98] urging USTR to raise defense offsets in priority.

In response to arguments that foreign countries will not agree to halt offsets unless the U.S. repeals the Buy America Act and other programs, the Commerce Department has estimated that such a trade would result in a net benefit for U.S. industry. Its most recent calculations indicate that trade as a result of defense-related Buy America purchases has been less than $1 billion annually.[99] In comparison, U.S. firms entered into defense offsets arrangements of approximately $10 billion between 1993 and 1996.[100] In response to arguments that foreign

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[94]*Id.* at 1 ("[O]ffsets are just one dimension -- and not necessarily the most important one -- of a much larger issue facing U.S. policymakers."); Mowery at 32 ("[D]ealing with the causes and consequences of aerospace offsets should be addressed as one element of overall policies to deal with international trade and investment, as well as the adjustment needs of U.S. workers affected by these trade and investment flows.").

[95]*See e.g., Mega-Consortium Concept Emerging,* Aviation Week and Space Technology, v.148, n.7, 25 (Feb. 16, 1998) (In an interview, Page Hoeper, Deputy Under Secretary of Defense for International and Commercial Programs, stated that "Governments' responsibility would be to assess future technological needs and facilitate the formation of consortiums, but it would be up to industry to make them happen.").

[96]*See* section II.C.

[97]*1997 National Export Strategy* at 53.

[98]Botwin Briefing II.

[99]*1998 Section 309 Report* (forthcoming).

[100]*Id.*

countries will not agree to cease offset demands, the Commerce Department complains that the U.S. has not been assertive enough in pressing for commitments and has not been willing to place this issue at the forefront of U.S. trade negotiations.

2. International Agreements Relating to Civil Aerospace Offsets

Although the Administration has had some success negotiating agreements regarding offsets in civil aerospace transactions, several obstacles have prevented universal application of offset prohibitions. International negotiations within the civil aerospace industry have been challenging because, in addition to purely commercial concerns, negotiators often face government intervention to secure domestic interests. For example, many airlines are operated by, or have some significant connection to, the governments of the countries in which they operate. Moreover, since transactions with these quasi-state entities may be viewed as government procurement, GATT's exemption for government procurement may apply, and its nondiscrimination rules would have no effect.

As discussed above, the Government Procurement Agreement does not effectively close GATT's government procurement loophole because countries were not required to accept its terms as a condition of WTO membership, and signatories were free to exclude certain types of purchases from the Agreement's scope. Because civil aerospace is one of the largest commercial sectors, and because the Agreement was only an initial attempt to apply nondiscrimination rules to government behavior, most countries were hesitant to expand their commitments to include civil aerospace.[101]

In addition, even if the government procurement obstacle could be overcome, states could resort to the national security exemption for refuge. Although the national security exemption's nexus to civil aerospace may seem more obscure than its nexus to defense aerospace, a country could claim, for example, that an offset requiring subcontracting of civil aircraft guidance systems is directly transferrable to defense applications and is therefore related to its national security. As mentioned above, the scope of the exemption is somewhat vague and subject to the interpretations of individual members.

Rather than attempting to push the limits of the original GATT agreement, major civil aerospace producers and purchasers concluded that this important, high-stakes, and lucrative industry deserved individualized treatment in a trade agreement of its own.

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[101]GATT's nondiscrimination rules could apply to purely private commercial aerospace transactions. In other words, GATT's rules on MFN treatment, national treatment, and domestic content could be interpreted to bar governments from requiring foreign manufacturers to meet offset obligations as a condition of dealing with domestic purchasers. Since many potential purchasers are state-run, however, this observation is of little assistance. In addition, although NAFTA explicitly bars the use of offsets, whether offsets are prohibited would depend on whether the three signatories agreed to include civil aerospace purchases within the scope of coverage.

a. Agreement on Trade in Civil Aircraft

In an effort to bring more clarity to international civil aerospace transactions, twenty-two GATT signatories adopted the Agreement on Trade in Civil Aircraft[102] during the "Tokyo Round" of GATT negotiations in 1973. This plurilateral trade pact applies to civil aircraft, engines, and ground flight simulators, whether they are used as original or replacement equipment in manufacturing, repair, maintenance, rebuilding, modification or conversion. Unfortunately, the Civil Aircraft Code includes language that only some countries interpret as prohibiting offsets. The primary provision at issue, Article 4.3, states that:

> Signatories agree that the purchase of products covered by this Agreement should be made only on a competitive price, quality and delivery basis.[103]

Since offset requirements almost invariably distort market factors, they appear to violate this provision. Additional provisions lend credence to this interpretation. Article 4.2, for instance, states that:

> Signatories shall not require airlines, airline manufacturers, or other entities engaged in the purchase of civil aircraft, nor exert unreasonable pressure on them, to procure civil aircraft from any particular source, which would create discrimination against suppliers from any Signatory.

A requirement that foreign manufacturers meet offset demands as a condition of doing business in a signatory's territory would seem to violate this provision. In addition, Article 4.4 states that signatories agree to avoid attaching inducements of any kind, and Article 5.1 states that signatories shall not apply quantitative restrictions or import licensing requirements inconsistent with GATT.

Read together, these provisions appear to prohibit offsets, and some commentators have reached this conclusion. Barber and Scott, in their report outlining challenges presented by offsets to the U.S. labor industry, state that the "1979 GATT aircraft code . . . bans offsets or other procurement requirements."[104] They admit, however, that there are numerous "wiggle words" that might suggest that the provisions are not absolute. For example, signatories agree that purchases "should" be made on a competitive basis and that they will not impose "unreasonable" pressure to buy from a particular source.

Alternatively, some commentators believe these provisions do not bar offsets. According

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[102] Agreement on Trade in Civil Aircraft, 31 U.S.T. 619, T.I.A.S. No. 9620, 1186 U.N.T.S. 170 [hereinafter Civil Aircraft Code].

[103] *Id.* art. 4.3.

[104] *Jobs on the Wing* at 68 ("Many of the practices described in this study would appear to be in conflict with the letter and spirit of international trade law.").

to Michael Levick, "the Aircraft Code . . . expressly allowed such pressure tactics."[105] These commentators point to the fact that countries have continued (and even increased) their use of offsets since becoming members to the Aircraft Code:

> In the 1980s and 1990s the Pacific Rim nations, along with other significant buyers of aircraft, have attempted to use their strong capital position as a means to bring the technology and jobs created from offset concessions to their developing civil aircraft industries.[106]

Even if the international community were to accept an interpretation prohibiting offsets, critics have complained that the agreement is ineffective because of the limited number of signatories. For example, the former Soviet Union and China are not members of GATT and have not signed the Civil Aircraft Code. In addition, the lack of transparency in transactions and the difficulties with enforcement pose additional obstacles. Since private manufacturers are dependent on their governments to represent their concerns within the WTO regime, it is left to governments to decide when or whether to assert manufacturer claims. Often, other diplomatic concerns may factor into these decisions.

b. E.C.-U.S. Interpretation

In 1992, the U.S. and the E.C. agreed to interpret the Civil Aircraft Code as prohibiting offsets. In the European Community-United States Agreement Concerning the Application of the GATT Agreement on Trade in Civil Aircraft in Trade in Large Civil Aircraft,[107] both parties concurred that the Civil Aircraft Code prohibits offsets. The legal basis for the interpretation was Article 4.3 of the Civil Aircraft Code. As stated in the E.C.-U.S. Interpretation:

> By emphasizing that the only factors which should be involved in purchase decisions are price, quality and delivery terms, the signatories agree that Article 4.3 does not permit Government-mandated offsets. Further, they will not require that other factors, such as subcontracting, be made a condition or consideration of sale. Specifically, a signatory may not require that a vendor must provide offsets, specific types or volumes of business

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[105]Michael J. Levick, *The Production of Civil Aircraft: A Compromise of Two World Giants*, 21 Transp. L. J. 434, 455 (1993) (footnotes omitted) ("Offset concession demands were commonplace in the industry as a means to gain technology and jobs for the buyer nation in exchange for the capital to develop aircraft.").

[106]*Id.*

[107]Agreement Concerning Application of the General Agreement on Tariffs and Trade to Trade in Civil Aircraft, Signed by the European Economic Community and the United States July 17, 1992, E.C.-U.S., 9 Int'l Trade Rep. (BNA) No. 30, at 1273 (July 24, 1992) [hereinafter E.C.-U.S. Interpretation].

opportunities, or other types of industrial compensation.[108]

This statement seems to answer definitively the question of whether the Civil Aircraft Code was meant to prohibit offsets. The E.C.-U.S. Interpretation clarifies other areas as well. For example, it explains that "unreasonable pressure" is any action favoring products or suppliers or influencing procurement decisions by creating discrimination against suppliers from any other signatory.[109] It also explains that the Civil Aircraft Code prohibits "negative or positive linkages" between the purchase of civil aircraft and other government decisions or policies that might influence the purchase when there is competition between suppliers.[110]

Complications arise, however, when attempting to determine the reach of the E.C.-U.S. Interpretation. One problem is that it applies only between the U.S. and Europe. Countries that did not sign this Interpretation may not consider themselves bound, especially in light of the uncertain application of the Civil Aircraft Code. In this sense, E.C.-U.S. efforts to "clarify" the offset prohibition in another agreement demonstrate that offsets were not originally prohibited in the Civil Aircraft Code.[111] The E.C. and the U.S. decided to forego challenging this questionable use of offsets under the Civil Aircraft Agreement and instead proclaimed their intentions to expand their Interpretation to all WTO members.

c. Outlook for Future Negotiations

In the landmark 1994 Uruguay Round WTO negotiations, negotiators concluded a new multilateral Agreement on Trade-Related Investment Measures that attempts to clarify GATT's domestic content provision by further illustrating the types of measures it prohibits.[112] For example, the TRIMs Agreement prohibits requirements to purchase products of domestic origin or from any domestic source, whether specified by proportion of volume or value of local production.[113] It also prohibits WTO members from requiring that an enterprise's purchase of

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[108]*Id. Interpretation of Article 4 of the GATT Agreement on Trade in Civil Aircraft by Signatories of the Agreement,* art. 4.3.

[109]*Id.* art. 4.2.

[110]*Id.* art. 4.4.

[111]One potential response is that the E.C.-U.S. Interpretation did not create a new international obligation but merely repeated in more clear terms the original offset prohibition in the Civil Aircraft Code. Although signatories to the Civil Aircraft Code are not bound by the new E.C.-U.S. Interpretation, they remain bound by the original terms of the Civil Aircraft Code, which prohibit offsets, although perhaps not as clearly as the E.C.-U.S. Interpretation.

[112]Agreement on Trade Related Investment Measures, Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 14, 1994, 33 I.L.M. 1145 (1994) [hereinafter TRIMs Agreement].

[113]*Id.* Annex § 1.

imports be limited to an amount related to the volume or value of local exports.[114]

Although the TRIMs Agreement may have clarified the GATT provision restricting governments from imposing domestic content restrictions to purely private transactions, it expressly retained GATT's exemptions, including the government procurement and national security provisions. In addition, although it prohibits many types of offsets that are based on domestic content restrictions, the Agreement never mentions or defines offsets specifically. As a result, there may be some dispute regarding whether certain types of offsets are prohibited by the terms of the Agreement.

In light of the fact that no further agreement was concluded on civil aircraft, Congress and the Administration agreed to outline potential goals for future civil aerospace negotiations in the Uruguay Round Agreements Act passed to implement the Uruguay Round of WTO trade negotiations.[115] In addition to discussing subsidies, transparency, and tariffs, it establishes that a primary objective for future negotiations is the elimination of nontariff barriers,[116] which include offsets. The legislation proposes doing this through expanding membership in the Civil Aircraft Code and the E.C.-U.S. Interpretation.[117] Unfortunately, this effort to "multilateralize" has produced no results. In fact, the E.C.-U.S. Interpretation itself may now be in jeopardy because its signatories pledged to reexamine its status if efforts to enlist additional signatories failed.[118]

D. Worker Assistance Programs Are Insufficient to Respond to Effects of Offsets

Prior to the conclusion of an international agreement restricting the use of offsets, or in its stead if no agreement can be reached, worker assistance programs could provide mechanisms to retrain workers affected by offsets for employment in other fields or to supply financial security for workers unable to convert their skills. Although the worker assistance programs that have been created, amended, and eliminated over the past decade have attempted to provide broad training strategies and remedy industry problems, none has addressed specific problems related to offsets. Some believe only a comprehensive program of worker assistance can counter effectively

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[114]*Id.*

[115]Pub. L. No. 103-465.

[116]*Id.* § 135(c).

[117]*Id.* The Statement of Administrative Action submitted to Congress with the implementing bill reiterates this goal: "The United States will also seek to ensure that all WTO members, as well as countries applying for WTO membership, that are involved in the development, production, and integration of aerospace products undertake the obligations of the Agreement on Trade and Civil Aircraft."

[118]E.C.-U.S. Interpretation art. 12.3.

the systemic changes now transforming the aerospace industry:

> Even the most effective set of international agreements, however, will not reverse the powerful trends that are increasing international collaboration in the military and civil aerospace industries. These trends may well increase the instability of aerospace employment and are likely to displace additional workers. Maintaining and liberalizing international trade in goods and technology in aerospace and other industries will remain difficult in the absence of a more coherent program of government assistance to aid workers (as opposed to their employers) in adjusting to the consequences of trade liberalization and economic change.[119]

Of the various programs developed to assist workers, most offer training assistance regardless of the reason workers are threatened with termination or layoffs. Only one, however, provides significant financial assistance, and this funding is provided only if workers can demonstrate their situations are a result of liberalized U.S. trade rules. Although no program specifically deals with the effects of U.S. companies sending jobs overseas to fulfill offset demands, one possibility open to policy makers is to review existing programs to evaluate whether they can be retrofitted to address these concerns.

1. Trade Adjustment Assistance and North American Free Trade Agreement Transitional Adjustment Assistance

Although the Trade Adjustment Assistance (TAA) program was designed to assist workers who are impacted negatively by the liberalization of U.S. trading policies, the extent to which it assists workers who suffer as a result of offsets is unclear.[120] The TAA was passed as part of the Trade Expansion Act 1962 and was developed to support workers through periods of unemployment due to U.S. efforts to lower trade barriers. Although the elimination of trade barriers was believed to benefit the U.S. economy generally, these programs were intended to address the corresponding dislocations that might occur in certain industries. The TAA program has been amended several times, the last of which was in the Omnibus Budget Reconciliation Act (OBRA) of 1993, when its authorization was extended through 1998.

Under the TAA program, workers are eligible for cash payments after they exhaust their unemployment compensation. Workers still receiving unemployment compensation may receive employment services, such as placement counseling, vocational testing, job search assistance, and job placement assistance. In addition, workers can receive job training, as well as job search allowances and relocation allowances. To be eligible for benefits under the TAA program, the Department of Labor must investigate and certify that:

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[119]Mowery at 35.

[120]*See generally* Congressional Research Service, *Trade Adjustment Assistance: The Program for Workers* (January 3, 1996) (Rep. No. 94-801 EPW); *see also* Congressional Research Service, *Trade Adjustment Assistance: Proposals for Renewal and Reform* (July 22, 1998) (Rep. No. IB98023).

(1) a significant number of workers have lost (or are threatened with losing) their jobs;
(2) the firm's sales or production have decreased; and
(3) imports are in direct competition with the firm's products and have contributed importantly to the decline in sales or production.[121]

Because the TAA program was intended to provide assistance to workers who lose their jobs as a result of U.S. trade restrictions being lifted, it is unclear whether workers who lose their jobs as a result of offsets can benefit from these programs. The potential harm caused by foreign offset demands cannot necessarily be traced to the liberalization of U.S. trade rules. Of the criteria above, the requirement to demonstrate harm from imports is the most relevant to the issue of offsets. A hypothetical example helps illustrate this uneven application:

> *Example: Suppose a foreign country demands, as a condition of purchasing U.S. fighter planes, that a U.S. manufacturer purchase all of its laptop computers from a company in the foreign country's territory. As a result, the U.S. manufacturer cancels its laptop contract with its current U.S. laptop supplier, and the supplier lays off dozens of workers.*

In this example, the offset results in imports that enter the U.S. in direct competition with U.S. products, so the workers who were laid off may be eligible for TAA.

On the other hand, in the case of technology transfers or subcontracting arrangements, workers may not be able to qualify for TAA:

> *Example: Suppose a foreign country demands, as a condition of purchasing U.S. fighter planes, that a U.S. manufacturer utilize a subcontractor in the foreign country's territory. As a result, the U.S. subcontractor that previously worked with the manufacturer goes out of business.*

In this circumstance, the foreign country is not sending products to the U.S. These fighter planes were intended for the foreign country, and the offset arrangement allowed the foreign country to employ workers in its territory. Since there are no imports to the U.S. to compete with the former U.S. subcontractor's products, U.S. workers who are terminated as a result may not qualify for TAA.

An addition to the TAA program made in the 1993 OBRA was the NAFTA Transitional Adjustment Assistance (NAFTA-TAA) program.[122] In response to fear that NAFTA would bring widespread worker dislocation, Congress created this program to provide TAA benefits to workers who lost their jobs as a result of changes made pursuant to NAFTA. The most significant difference between TAA and NAFTA-TAA is that workers may qualify for NAFTA-

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[121] *See id.* at 6.

[122] *See generally* Congressional Research Service, *Adjustment Assistance for Workers Dislocated by the North American Free Trade Agreement* (Nov. 14, 1995) (Rep. No. 94-52 EPW).

TAA benefits by showing either the impact of imports or that U.S. firms have moved to Canada or Mexico.

Applying these criteria to the two examples above, workers in both situations may be able to qualify for NAFTA-TAA assistance. First, workers who lose their jobs as a result of the laptop offset could continue to claim direct competition with foreign imports. In the second example, workers could claim that their job loss is a result of U.S. manufacturers moving jobs to another country. Unfortunately, the NAFTA-TAA program extends assistance to the latter group of workers only if the manufacturers move jobs to Canada or Mexico. The Administration has recognized this disparity in the past and has proposed expanding the NAFTA-TAA eligibility criteria to all countries.

In addition to the uneven application of the TAA eligibility requirements to workers harmed as a result of offsets, a more practical obstacle is that authorization for this program expired on September 30, 1998. Although Congress previously extended authorization in 1993 for five years, and although the Administration had included funding for reauthorization in its FY 1999 budget proposal, no long term extension has been passed. In fact, authorization was defeated in the House of Representatives as part of a vote on "Fast Track" negotiating authority, and was not raised in the Senate. Recently, however, both houses of Congress passed the conference report providing funding for these programs through June 30, 1999.[123]

2. Economic Dislocation and Worker Adjustment Assistance

Unlike the TAA and NAFTA-TAAP programs, the Economic Dislocation and Worker Adjustment Assistance (EDWAA) program provides assistance to workers dislocated for any reason.[124] EDWAA is permanently authorized under Title III of the Job Training Partnership Act (JTPA) and provides four general categories of assistance:

(1) rapid response to impending or ongoing layoffs;
(2) basic readjustment, such as occupational skill testing, job and career counseling, and relocation assistance;
(3) retraining, including classroom, on-the-job, and remedial training; and
(4) limited income support.[125]

Although EDWAA includes some limited financial support, the program's primary focus is training workers and helping them find positions in different, but comparable fields.

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[123]H.R. Conf. Rep. No. 825, 105th Cong. 2d Sess. (1998) [hereinafter 1999 Omnibus Appropriations Bill].

[124]The EDWAA and other Job Training Partnership Act (JTPA) programs are described in more detail in Congressional Research Service, *The Job Training Partnership Act: A Compendium of Programs* (Sept. 25, 1997) (Rep. No. 94-862 EPW).

[125]*Id.* at 15-16.

Since eligibility for EDWAA is open to workers regardless of the cause of their dislocation, those who suffer as a result of U.S. companies submitting to foreign offset demands would be permitted to participate in its training programs. Wide categories of workers are eligible for EDWAA, including:

(1) workers who have lost their jobs (or have received termination notices) and are unlikely to return to their previous work;
(2) workers terminated (or with termination notices) as a result of a permanent closing or substantial layoff;

(3) long-term unemployed with limited opportunities for similar employment in their areas of residence; and
(4) self-employed workers unemployed as a result of general economic conditions or natural disasters.[126]

If workers fit into any of these categories as a result of foreign offset requirements, they may be able to access any of the assistance described above.

In addition, workers could be eligible for additional assistance through a separate, discretionary fund. The Secretary of Labor is directed under the EDWAA program to withhold 20% of the allotted funding for use in case of unforeseen circumstances.[127] Although some of this amount is designated for specific uses, grants could be directed toward workers displaced because of offsets. Since overall funding for EDWAA training programs has been increasing steadily over the past several years, this discretionary percentage also has been growing.

3. Defense Conversion Assistance

The Defense Conversion Assistance (DCA) program was designed specifically to assist workers who lost their jobs or were terminated because of defense downsizing. Although this program would have been uniquely suited to assist defense workers whose companies increase foreign subcontracting through offset arrangements, it provided little cash assistance and its authorization has expired.

The DCA program was added as part of the Job Training Partnership Act by the National Defense Authorization Act for FY 1991.[128] Its objective was to extend to workers dislocated because of reductions in defense spending the same services and training assistance provided under EDWAA program. As mentioned above, EDWAA services include training and retraining programs, as well as counseling and other services, but provide limited cash assistance.

Although the services provided under the DCA program were substantially similar to

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[126] *Id.* at 16.

[127] *Id.* at 16-17.

[128] *Id.* at 19.

EDWAA assistance, workers were required to demonstrate additional factors to qualify for this assistance. Besides EDWAA eligibility, workers were required to show that they were laid off, terminated, or received layoff or termination notices, as a specific result of reductions in defense spending, base closures, or fewer defense exports.[129] Workers were willing to demonstrate their enhanced eligibility, however, because DCA funds were provided in a separate, dedicated pool available only to workers who met these additional conditions. By contrast, EDWAA funds often were depleted relatively early in the year.

Since this program initially was intended to be a short-term remedy for downsizing during the early 1990s, it was authorized for only five years. Congress originally appropriated $150 million for this program in FY 1991, but this amount expired in 1997 and was not renewed.[130]

4. Defense Diversification Program

The Defense Diversification Program (DDP) was created as part of the JTPA by the Defense Authorization Act for FY 1993.[131] In addition to providing EDWAA-type assistance, the DDP program provided funds for upgrading skills of nonmanagerial employees, developing high performance workplace systems, encouraging participative management systems, and furthering employee participation in evaluation, selection, and implementation of new production technologies.

The DDP program extended eligibility to any of the following workers, so long as they were not entitled to retirement or retainer pay:

(1) members of the armed forces or National Guard on active duty or employed full-time on September 30, 1990, who were separated from duty involuntarily within the next five years;
(2) civilian employees of the Department of Defense and the Department of Energy terminated or laid off (or with termination or layoff notices) due to reductions in defense spending or closure or realignment of military installations within five years after October 1, 1992; and
(3) defense contractor employees terminated or laid off (or with termination or layoff notices) due to reductions in defense spending, closure or realignment of military installations, or fewer defense exports, within five years after October 1, 1992.[132]

This program funding also was intended to be a short-term remedy for the effects of defense downsizing. Although $75 million was originally appropriated in 1993, these funds expired the

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[129] *Id.*

[130] *Id.*

[131] *Id.*

[132] *Id.* at 20.

following year.

IV. RECOMMENDATIONS

A. Strengthen U.S. Policy by Establishing a High Level Offsets Commission

In 1990, GAO concluded that President Bush had failed to implement all of the requirements of the 1989 Defense Authorization Act. That law required the President, among other things, to establish a comprehensive offset policy addressing: (1) technology transfer; (2) U.S. financing of offset arrangements; and (3) the effects of offsets on specific subsectors of the U.S. industrial base. During the Clinton Administration, the interagency Trade Policy Coordinating Committee adopted a stronger statement concerning offset policy, but it remains effectively a policy of noninvolvement. In order to address adequately the differing concerns of those affected by offsets, Congress should establish a commission, composed of representatives of government, all affected industry sectors, labor, and academia, to review current offset policy, recommend modifications to the current policy, and propose a coordinated plan for the reduction of detrimental effects of offsets.

B. Enhance Information Gathering

1. Require that Relevant Offset Documentation Be Provided to BXA

Firms in the U.S. routinely supply foreign governments with detailed information on fulfillment of their offset obligations. Congress should require that copies of all such information and all offset transaction papers be provided to the Bureau of Export Administration. Because such information may contain confidential or proprietary information, it should be retained as confidential material and used in the aggregate to more accurately assess the impact of offsets on employment, suppliers, and the broader industrial base.

2. Require Reporting on Offsets in Civil Aerospace Sales

Currently, U.S. manufacturers are required to report only offset agreements related to defense aerospace products. In the interest of further understanding the impact and trends of offsets in civil aerospace transactions, companies should be required to provide information on these types of offset arrangements, as well. Legislation applying the defense reporting requirements, as modified above, to civil aerospace manufacturers would accomplish this objective.

C. Increase Protection in International Agreements

In order to address the lack of an international offset control regime, the U.S. must definitively conclude its attempts to establish domestic consensus. The issue should not be whether to pursue international negotiations, but how best to bring them about. Congress should enhance the prospects for stronger international agreements by enacting legislation that encourages the Administration to negotiate international agreements that prevent the use of offsets. As discussed below, there are numerous upcoming opportunities available to the

Administration for concluding such agreements. Ideally, such legislation also should encourage clarification of existing agreements and should establish, or require the Administration to establish, timelines for demonstrating concrete progress on offsets.

1. Transatlantic Economic Partnership

The Transatlantic Economic Partnership (TEP) agreement is a "joint statement" that was issued in May of 1998 by the U.S. and the European Union proclaiming each party's intent to work together to reduce trade barriers bilaterally in a variety of areas and to cooperate with each other in upcoming rounds of WTO negotiations. On the agenda is government procurement, both with respect to bilateral and multilateral relations. Although there is no specific mention of the use of offsets, both sides agreed to establish a "Plan" to identify areas for common action, with a timetable for achieving specific results. Both sides also agreed to take all necessary steps to allow rapid implementation of the Plan, including any necessary authority to start negotiations. The European Union has submitted its draft of the Plan, and U.S. agency officials are working on a response. The U.S. response should propose including offsets on the TEP agenda.

2. Future WTO Negotiating Rounds

Perhaps the most appropriate fora for discussions on limiting the practice of offsets are future rounds of WTO negotiations. Successful negotiations in this arena would provide the type of breadth that would protect manufacturers from losing business to companies from countries that do not prohibit offsets. As one potential negotiating forum, the WTO Government Procurement Committee is now in the process of debating interpretations to various parts of the Government Procurement Agreement. The consideration of offsets should be proposed there and during other upcoming WTO negotiations.

3. Focused Country-Specific Negotiations

In addition to broad multilateral negotiations, additional opportunities may arise to influence the offset policies of key countries. For example, China's desire to become a member of the WTO will be conditioned on significant reforms and other measures decided upon by WTO members. Although there may be numerous other agenda items for WTO members considering China's accession, the reduction or elimination of offsets should be added to this list. This emphasis would not be misplaced since China currently has the world's fastest-growing air travel market.[133] These focused negotiations may be able to pinpoint affected industry sectors

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[133]Mowery at 29-30. Mowery writes:

> As China's economy continues to grow rapidly, demand for air travel in China is projected to grow more rapidly than any other market. At present, entry into the Chinese market is closely controlled by the central government, and foreign manufacturers of commercial aircraft face significant demands for direct and indirect offsets. Since overt government pressure for various types of performance requirements in civilian products is subject to disciplines under the WTO's Uruguay Round accords, the terms under which

and offset offenders.

4. Multilateral Agreement on Transparency in Government Procurement

The Department of Commerce and USTR are working jointly within the Government Procurement Committee toward a potential multilateral agreement on increased transparency measures in government procurement. Unlike plurilateral WTO pacts, this agreement would be binding on all WTO members as a multilateral agreement. Although this would not be a long-term solution to the problem of offsets, it may inform the debate further by illuminating the factors on which government procurement transactions are based.

5. E.C.-U.S. Interpretation of the Civil Aircraft Code

As an alternative or supplement to efforts to negotiate new international agreements, the U.S. could achieve important restrictions on offsets by clarifying the interpretation of existing agreements. For example, only the E.C. and the U.S. currently interpret the Civil Aircraft Code to prohibit governments from demanding offsets in civil aerospace transactions. Although both signatories agreed that they would encourage other countries to adopt their interpretation, efforts to "multilateralize" have been unsuccessful to date. The U.S. should explore other ways to persuade countries to adopt the E.C.-U.S. Interpretation.

6. Indirect Offsets and Scope of National Security Exemption

Although it is clear that indirect offset arrangements do not technically further essential national security interests, they often are justified on these grounds. In light of the recent increase in indirect offsets, the objective of curtailing this practice has gained prominence and urgency. In addition to raising this argument in formal dispute settlement mechanisms, the U.S. should pursue a limited, clarifying statement explaining that indirect offsets are not permissible under the national security exemption. A key component of this strategy would be ensuring wider adoption of the Government Procurement Agreement, as well as its application to at least some defense aerospace equipment.

D. Address Worker Dislocation Programs as They Relate to Offsets

Congress should address the effects of worker dislocation and termination resulting from foreign offset demands not only by attempting to negotiate an international agreement but also by providing worker assistance programs to employees who are affected adversely by offsets. A

China is allowed to join the WTO may constrain these demands for offsets. Successful demands by Chinese negotiators for lengthy transition periods in meeting provisions of the WTO agreement, however, could mean that demands for offsets will remain intense for the next two decades.

Id.

brief analysis of these programs suggests several alternatives:

1. Reauthorize the TAA and NAFTA-TAAP Programs and Cover Workers Displaced Because of Foreign Offsets

The TAA and NAFTA-TAAP are the most significant financial assistance programs for U.S. workers. Authorization for these programs, however, expired on September 30, 1998. In order to assist U.S. aerospace workers, Congress could reauthorize these programs. In addition, Congress could cover more workers affected by foreign offset demands by adopting the Administration's proposal to extend TAA eligibility criteria to workers who suffer from firm relocation to any country, rather than to Mexico and Canada alone, as in the NAFTA-TAA program.

2. Prioritize the Secretary of Labor's EDWAA Discretionary Fund

Only 80% of EDWAA funding is dispersed directly through specified statutory training programs. The remaining 20% is allotted to a discretionary fund the Secretary of Labor may use for unforeseen circumstances. By further prioritizing this discretionary fund by statute, Congress could ensure that additional funding is directed toward workers who are dislocated as a result of foreign offset demands. One benefit of this option is that it would require no additional federal outlay of resources since funds already are authorized and appropriated. As mentioned, however, benefits are more limited and rely on training over cash assistance.

3. Create a New Program to Address the Specific Effects of Foreign Offset Demands on U.S. Workers

As part of a comprehensive legislative response to offset-related employment problems, Congress could consider creating a new training and support assistance program for the specific benefit of workers directly affected by foreign offset demands. Rather than reviving or amending the DCA and DDP programs, Congress could examine these programs as models that extended training and resource benefits to specific industries and workers. Although it currently may be difficult to isolate the effects of offsets on particular sectors, firms, or workers, a system that operates in conjunction with enhanced reporting requirements may help provide additional transparency in these transactions and help identify workers displaced because of foreign offset requirements.